Setting the Stage for OPEB bonds

By GIRARD MILLER

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A silver lining to a 'perfect storm'

The economy keeps looking worse, and stock prices have fallen to new lows. It's now a "perfect storm" for state and local governments who already face acute budgetary pressures — just as they begin to budget money to fund their retiree medical benefits (OPEB). And many underfunded pension plans could soon see their actuarial status erode, requiring increased employer contributions. Talk about a triple whammy!

Yet there now could be a silver lining in these storm clouds, in the form of "benefit plan bonds" — which include OPEB bonds and pension obligation bonds. (OPEB stands for "other post employment benefits" in the special world of governmental accounting.)



Questions, success stories or anecdotes about benefit issues in government? Girard Miller wants to hear from you. E-mail him

As readers of my previous columns on OPEB bonds know, I have heretofore urged municipalities to resist earlier self-interested pitches by underwriters and advisers to issue OPEB and pension bonds, given my belief that lower stock prices lay ahead and the timing just wasn't right. Sensing that the economy could worsen and market levels decline further, it made no sense to me to borrow money in order to lose money. The smarter strategy was to wait until a weaker economy was bad enough that nobody wants to buy stocks, and then use that point to implement an OPEB bonding program. Last New Year, with the Dow Jones Industrials Average at 13,000, I announced a target DJIA level of 11,000 as a reasonable trigger point for issuing these benefit plan bonds, because that was the nearest "round number" at which the stock market will have fallen 25 percent below its all-time peak level of DJIA 14,150 set in October 2007. Historically, the popular Dow stocks have fallen an average of 25 percent in recessions (28 percent on the broader S&P 500), so that seemed to be a prudent and politically defensible level from which to launch a long-term debt-funded investment and financing strategy.

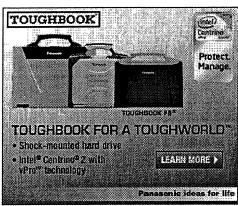
My cautious advice of the past 15 months has proved sound, and readers who followed it saved many millions of dollars. Municipalities that prematurely issued OPEB and pension bonds in the past two years are now underwater, as the stock market recently fell to 20-month lows (see the latest numbers here). And some who invested in "structured" OPEB debt deals, like the school districts in Wisconsin whose collateralized debt obligation portfolios are now underwater, have also seen their na ve use of leverage backfire in the subprime market meltdown.

Meanwhile, the economy has continued to deteriorate, with housing values declining in most parts of the country. According to one national index, house values have fallen more in the past year than they did in any year in the Great Depression. Home prices could easily fall another 10-15 percent nationally before they reach equilibrium, according to many market experts. That erosion of the property tax base will hit local governments especially hard in the coming year, just at the same time that many will begin to book their actuarially based contributions for their retiree medical benefits plans in order to meet new accounting standards. Likewise, sales tax revenues are expected to decline as consumer confidence plunges at a rate that historically has always accompanied a recession. (Note the coinciding grey recessions in this chart.)

This perfect storm of recession-cycle OPEB funding will confront many states and municipalities in the coming year, as they begin making actuarially required contributions (ARC) to fund their existing unfunded OPEB obligations, just as their revenues stagnate or even decline.

Ironically, the very malaise that undermines governmental revenues may now set the stage for a financial strategy that could enable many public sector employers to begin funding their OPEB liabilities and underwater pension funds on a systematic basis. At a







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minimum, it is time now for many public agencies to begin considering OPEB bonds and (for some) related pension obligation bonds, at least on a strategic level.

Naturally, I would be more comfortable pulling the trigger to start the OPEB bond issuance process if the Dow Industrials were already below 11,000, and if bond interest rates were near their cycle lows. Conditions outlined in my original April 2007 column on this topic have not yet aligned quite as perfectly as the stars and the moon might under an ideal scenario. But if the economy weakens further and the bear market deepens, then OPEB bonding conditions could approach perfection. Meanwhile, waiting any longer to inaugurate this "OPEB bond watch" column could waste valuable planning time, as discussed below. So I am publishing my analysis now because the launch window for this strategy will not stay open indefinitely.

In today's 'stagflationary' environment, bond yields may not move much lower (and OPEB bonds could add to the supply of new issues, which pushes yields higher). And I'm doubtful that a few more percentage points downward on the Dow are worth waiting for — at least for planning purposes. I have worked with governmental decision-makers for 30 years and know only too well that sometimes it takes months for an idea to be researched, deliberated and ultimately adopted. If labor union discussions are required to adjust the benefits plan, it takes even longer. Meanwhile, downbeaten equity markets could eventually rally in anticipation of economic recovery, and leave procrastinators behind.

Consider these historical data: Average recessions have run 10 months, and historically stock prices have started recovering 4-5 months before the general economy perks up. Average bear markets have run 13 months (both the Dow and the S&P peaked in early October 2007). Once stocks have bottomed, they often rallied sharply in the ensuing recovery, especially after "capitulation selling" such as in 2003. Hence, an ultracautious "wait-and-see" strategy could leave OPEB procrastinators belatedly "chasing the caboose" if they wait too long past the November elections, hoping to pinpoint a market bottom or hopelessly mired in meetings.

In the real economy, we already know that subprime adjustable-rate mortgage resets will crest at year-end. By then, the oncoming flood of 3 million distressed property sales and unsold inventories could also begin receding as prices below construction cost begin to attract scavenger buyers. Although a nationwide housing recovery is unlikely before late 2009, there could be early signs of a bottoming process earlier next year. Unless other economic sectors and markets begin failing then, Wall Street might sense a turnaround ahead by election time.

So now is probably the right time for agile, foresighted financial officials to start their work on benefit plan bond strategies with sufficient lead time to close and fund their OPEB portfolios near a statistically-average trough period. There are no better reference points than those above, to objectively and defensibly guide a public process that inherently includes elements of cyclical timing. This is about as systematic as one can be in an uncertain milieu of greed and fear, global discontinuity, stagflation, diverging markets and domestic economic malaise in a world of Asian expansion.

The payoff could be a lower long-term cost of funding these benefits than through conventional actuarial amortization ("soft debt"), especially in the initial years. This is one instance where financial professionals and policymakers can make lemonade from lemons, if they do their homework and think it all through.

Some public employers may conclude that with a 20- or 30-year horizon, it is not necessary, feasible or prudent to wait for possible further declines in the stock market. Given their precarious fiscal situation, a debt-funded program may be structurally preferable to large actuarial deficits and current budgetary underfunding. For example, the repayment plan can be structured to accommodate a gently phased ramp-up in budgetary costs that avoids deficiently underfunding the ARC if the employer is short on cash in 2009-10, by making those initial years "interest only."

For those who determine that their borrowing capacity will not be unduly eroded, or that they can issue alternative debt forms like certificates of participation, the key tactical question regarding OPEB and pension bonds eventually becomes one of timing. Ideally, a state or municipality would sell these bonds at the exact stock market bottom — at a time when interest rates are also at low levels because of an associated recession and "flight to quality." Unfortunately, nobody ever achieves perfection in their market timing. That's like hitting consecutive bulls-eyes in long-distance archery. The closest a large issuer ever came was Contra Costa County, California, with its early 2003 pension obligation bond issue, which was completed at levels very close to the market bottom.

But when stocks have already declined by a percentage equal to the 60-year average of prior recessions, the odds strongly favor long-term success. From these levels, as long as stocks earn at least 60 percent of their historical returns over the next 20-30 years, an OPEB bond strategy should work. Viewed another way, stocks must ultimately outperform bonds over the life of the bond issue, which has historically has happened 99 percent of the time over 20 year periods according to research published by the Federal Reserve Bank of Kansas City.

I have conducted independent research on this risk of underperformance, and could find

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only one multi-cycle period of 20 or more years since the Depression in which stocks failed to ultimately outperform bonds when they were purchased in recessions after equity prices had already fallen 20 percent. Importantly for debt issuers and plan trustees, I found no such 30-year periods since the Depression. In a separately published 50-year study, there were no such 20-year (rolling 240-month) periods of stocks underperforming bonds regardless of the entry point. That study also found, however, that significant systematic withdrawals could impair the success ratio because cash would flow out when stock prices are down. This finding suggests that an optimally sized OPEB bond issue should be smaller than the unfunded actuarial liabilities if benefits payments are made largely from the long-term portfolio.

From a publicity as well as an economic standpoint, there is no risk today of buying stocks at a market peak, as there was in 2007. However, there is still a risk that stock markets could decline even further in a lingering recession and leave OPEB bond issuers with "buyers' remorse" that they didn't hold out for lower stock prices. And as they say in investment company compliance departments, 'past performance is no guarantee of future returns.' Skittish issuer-investors might prefer to initially sell only a portion of the ultimate level of debt that might be authorized, with the expectation of completing the funding program later if the economy worsens, or possibly even after the stock market begins to recover. This multiple-entry-point strategy can mitigate short-term stock market risks as long as issuance costs are relatively negligible. It balances the risk of a later plunge in stock prices with the opposite risk that the economy could level out sooner than many expect — and stocks begin to regain their footing as they did in 1988 and 1998, when comparable mid-cycle Wall Street crises were both followed by 40 percent market run-ups.

When issuing bonds, a strategic plan becomes essential. Investors and rating agencies want to see that the homework is complete. The financial team needs to explore and document the strategic, tactical and cyclical scenarios — and develop a recommendation coupled with alternatives for discussion so that elected officials can understand in advance the implications, mechanics, opportunities and risks of various strategies.

Controlling the future benefits liability with inflation caps, payout ceilings, rising eligibility hurdles and escalating co-pays — plus a cost-limiting defined contribution plan for future hires — will also make OPEB bonds more marketable to investors. That will reduce borrowing costs and further enhance the odds of financial success. This is why a comprehensive OPEB strategic plan is so valuable.

OPEB bonds are not a panacea and they certainly aren't the solution for everybody. The Government Finance Officers Association's admonition to exercise caution still applies, even when market conditions are favorable.

So, at this timely juncture, I'll flash a "Yellow Light — Proceed with Caution" signal to financial managers and benefits professionals. Learn more about OPEB bonds, reassess your plan design and funding options, confer with the appropriate expert professionals, and develop a comprehensive long-term funding and benefits plan design strategy. Even if you ultimately decide to defer a debt issue until the next economic recovery begins, or discard the strategy as unfeasible in your jurisdiction, you will learn more about your funding options and put yourself ultimately on the right course by conducting the analysis. Remember: Hope is not a strategy!

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